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C O N F I D E N T I A L SECTION 01 OF 03 TAIPEI 004095

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TAGS: EINV ECON EIND ETTC PREL CH TW
SUBJECT: ASE-CARLYLE DEAL - MONEY, POLITICS, AND TAIWAN'S
FUTURE

REF: A. 05 TAIPEI 2743

¶B. TAIPEI 2919
¶C. TAIPEI 3985

Classified By: AIT Economic Section Chief Daniel K. Moore, Reason 1.4 b
/d

¶1. (C) Summary: The Carlyle Group's planned acquisition of Advanced Semiconductor Engineering (ASE) set Taiwan abuzz over the pros and cons of the island's cross-Strait restrictions on investment. ASE emphasized it is primarily motivated by a desire to form closer relationships with other semiconductor firms owned by Carlyle. However, an ASE executive acknowledged to AIT that cross-Strait restrictions were a factor in the deal. The Carlyle acquisition would give ASE more freedom to realize its ambitious expansion plans in the PRC. Cross-Strait restrictions also helped reduce ASE's stock price, making it an attractive target. President Chen made a highly publicized trip to the firm to portray the deal as beneficial to Taiwan's economy. Even though Taiwan's regime of cross-Strait restrictions is not the most important factor, the deal highlights how the restrictions are ineffective at preventing investment in the Mainland and how they can help encourage firms to leave Taiwan. End summary.

¶2. (U) The November 26 announcement by Carlyle Group, a Washington D.C. based investment firm, that it wishes to acquire ASE, the world's largest semiconductor packaging and testing firm, has stirred up Taiwan's business community and political circles with discussion about cross-Strait restrictions and Taiwan's economic future. As reported ref C, Carlyle wants to buy ASE for NT$39 (about US$1.20) per share. ASE closed at NT$36.7 on December 8. The total acquisition cost has been estimated at US$5.45 billion. ASE Chief Financial Officer Freddie Liu told AIT that the deal could take up to six months to complete.

What's in It for Carlyle, ASE?

¶3. (C) Liu explained to AIT that the Carlyle Group was investing in ASE because they recognized the value in the

firm and believed that it was undervalued. Liu believes the entire Taiwan Stock Exchange is undervalued, blaming political factors such as instability and cross-Strait relations.

¶4. (C) According to Liu, ASE will benefit from closer relationships with other semiconductor firms that Carlyle has purchased. Liu commented that the global semiconductor industry was headed toward consolidation and ASE wanted to be leading the trend. He pointed out that Carlyle had substantial investments in Freescale and Philips Semiconductor. Media reports have also highlighted Carlyle's investments in Jazz Semiconductor, Toshiba Ceramics, and AZ Electronics.

The China Factor - Investment Restrictions

¶5. (C) Since the announcement, Taiwan's media has been abuzz with speculation the deal was primarily motivated by ASE's desire to get around Taiwan's cross-Strait restrictions on investment and expand operations in the PRC. Liu acknowledged that cross-Strait restrictions on investment were a factor in the deal, but insisted it is only a minor factor. He told us the acquisition by Carlyle should give ASE more freedom to expand in Mainland China.

¶6. (C) All firms registered in Taiwan are subject to limits on the percentage of total capital they can invest in the PRC. Although the restriction is commonly called the 40 percent ceiling, it is actually a sliding scale of limits that restricts large firms, like ASE, to substantially less than 40 percent of total capital as

explained in ref C. Liu confirmed that ASE has to date invested only 10 percent of its total capital in the Mainland. ASE recently applied to the Ministry of Economic Affairs Investment Commission (MOEA/IC) for approval to acquire Global Advanced Packaging Technology (GAPT), a packaging and testing firm located near Shanghai. That acquisition will bring ASE's total investment in the PRC up to 14 percent. Liu commented that given ASE's current expansion plans for China, it would not reach the investment ceiling for the next two to three years. (Comment: This seems to us like a relatively short time frame. If ASE believes that it might reach the 40 percent limit in as little as two years, preparing now for that possibility seems like a sound strategy. End comment.)

¶7. (C) ASE is also subject to industry-specific restrictions on investment in the Mainland. Investment in any packaging and testing facilities was prohibited by the Taiwan government until April 2006. Now investment in relatively low-technology packaging and testing facilities is permitted. Liu has previously complained to us that the MOEA/IC had not yet made clear what kinds of technology qualified under the new regulations (ref B), but told us more recently that GAPT's technology should not be a problem. He added that with the current market in China, ASE should be able to meet most demand for packaging and testing services with low-end technology. To date, MOEA/IC has yet to approve an application for packaging and testing investment in the PRC. ASE's acquisition of GAPT may be the first. MOEA/IC Deputy Executive Secretary Emile Chang told us that MOEA/IC is still not sure that GAPT's technology is compliant with the investment regulations. MOEA/IC has asked ASE for more information about the firm.

¶8. (C) Liu explained to us how the Carlyle acquisition will give ASE more freedom to invest in the Mainland. According to Liu, Carlyle will purchase 100 percent of ASE and likely de-list it from the Taiwan stock market.

It will form a holding company registered elsewhere that will own ASE as a subsidiary. That holding company and any other subsidiaries that it registers outside of Taiwan will not be subject to Taiwan's restrictions. This kind of strategy is not unprecedented in Taiwan's semiconductor packing and testing industry. United Test Assembly Center Limited, which was founded in Taiwan, moved its headquarters to Singapore and registered there in part to avoid Taiwan's restrictions (ref A).

¶9. (C) ASE has ambitious plans to expand in the PRC. It has already purchased IC substrate manufacturing operations near Shanghai. As reported ref A, Liu told us last year that ASE hopes to employ 200,000 in the Mainland by 2016, compared to current employment in Taiwan of about 30,000. Liu said that Taiwan did not have adequate human resources for ASE to fulfill its expansion plans on the island.

The China Factor - Stock Price

¶10. (C) Another way that cross-Strait restrictions have affected the ASE-Carlyle deal is by lowering ASE's stock price and making it a more attractive target. Liu commented that the Taiwan market is undervalued overall because of political instability and cross-Strait restrictions that limit the ability of Taiwan firms to expand in the Mainland. Citigroup Head of Taiwan Country Research Peter Kurz agrees with Liu, adding recent reductions in tax benefits for high-tech firms as another cause for underperformance compared to other markets in the region. Kurz noted that ASE's price-earnings ratio was about 9.5. By comparison, Amkor, a U.S. firm that trades on the NASDAQ, has a P/E ratio of about 11.6. Kurz added that Amkor, which is the world's second largest packaging and testing firm, has suffered recent difficulties, including a threat to declare bankruptcy in response to creditors accusing it of default. ASE, on

the other hand, has not experienced these kinds of operational difficulties.

¶11. (C) The ASE-Carlyle deal has caused speculation in the Taiwan market about which firm might be the next likely target for a foreign takeover. Kurz said that United Microelectronics Corporation (UMC), the world's second largest contract semiconductor manufacturer, has been identified by many as a possible target. UMC has been accused of investing illegally in the Mainland and its former chairman and vice chairman are under indictment. Kurz said a foreign buyout could help resolve these problems. He noted that its stock value had declined in recent months and would have declined further if the company had not bought back large amounts of stock. The ASE-Carlyle deal helped drive UMC's stock price up almost 7 percent the day after the announcement. The possibility that the ASE-Carlyle deal and ASE's likely delisting could become a model for other Taiwan firms will increase concerns about the competitiveness of Taiwan's stock market and the financial sector as a whole.

Political Reaction - Blues and Greens

¶12. (C) Taiwan media have reported heavily on the political reaction to the ASE-Carlyle deal. Many reports have focused on efforts by pan-Blue legislators to pass a bill that would relax the 40 percent ceiling on investment. However, Kuomintang (KMT) Legislator Lee Jih-chu denied reports that her support for relaxing the rule was connected to the ASE-Carlyle deal, acknowledging that ASE has not yet come close to reaching the 40 percent ceiling.

¶13. (C) President Chen Shui-bian has reacted vocally to the deal. Immediately after the announcement he highlighted the deal as evidence that Taiwan was a good place to invest. On December 6, both President Chen and Premier Su Tseng-chang visited ASE's headquarters in Kaohsiung. During the visit, ASE chairman Jason Chang pledged to keep ASE's "roots in Taiwan" and announced the firm planned to invest more than US$3 billion on the island. ASE's Liu commented that it was a rare occasion for Chen and Su to conduct a joint visit, showing how politically important it was for the ruling Democratic Progressive Party (DPP) to portray the deal as positive for Taiwan's economy. He also acknowledged that ASE was actively trying to maintain good relations with the Chen administration to ensure approval of the Carlyle deal.

¶14. (C) Liu noted that ASE had not planned to announce the deal in late November. Instead, the firm had planned to announce it after the December 9 Taipei and Kaohsiung mayoral elections. However, Liu explained that the information was leaked and ASE had to go public.

Comment - Minor Factor with Major Implications
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¶15. (C) ASE Chairman Chang has gone to great effort to publicly proclaim that the ASE-Carlyle was not designed to get around cross-Strait restrictions. His Chief Financial Officer, Liu, stuck to the company line even while acknowledging cross-Strait restrictions were a minor factor. Although cross-Strait restrictions are probably not the most important factor, they have helped drive this deal by making a new ownership structure more advantageous for ASE and helping to deflate ASE's stock price, making it an attractive target. The deal is a complex one and Taiwan's regime of cross-Strait restrictions is only one piece of the puzzle. However, Carlyle's offer further illuminates how Taiwan's cross-Strait restrictions are not effective at keeping Taiwan's most competitive firms out of the Mainland and could actually help drive firms out of Taiwan.
YOUNG